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# Welsh Economic Review

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The *Welsh Economic Review* is produced twice yearly, by the Welsh Economy Research Unit (WERU) at Cardiff Business School. The aim of the *Review* is to provide an authoritative and objective analysis of the Welsh economy in a manner that promotes understanding and informs decision-making. The 'core' section of the Review is written by members of WERU, with feature articles contributed by academics or practitioners within or outside Wales. The *Review* is circulated widely within Wales, to both private and public sector organisations, including the education sector and the National Assembly.

**Notes for Contributors**

Authors should send papers for potential publication in the *Welsh Economic Review* to the Editor at the address given below, preferably via e-mail in a Word for Windows format. Papers are welcome on any topic that would be of general interest to the readership, and should be written in a style suitable for non-specialist readers. Papers should be approximately 3,000-4,000 words and any graphs or figures should be accompanied by the underlying data to allow reproduction.

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Dr Annette Roberts,
Editor, *Welsh Economic Review*,
Welsh Economy Research Unit,
Cardiff Business School,
Aberconway Building,
Colum Drive,
Cardiff, CF10 3EU.

Tel 029 2087 4173
Fax 020 2087 4419

e-mail robertsa1@cardiff.ac.uk

£35

# Economic Commentary

## The World Economy

Recent estimates for world economic growth show Gross Domestic Product (GDP) to have risen, on average, by almost 5% in 2000, with Organisation for Economic Co-operation and Development (OECD) economies experiencing GDP increases of 4.2% (NIESR). Despite this there are concerns that growth in the two largest economies, the USA and Japan, is beginning to falter. Actual GDP growth in the USA slowed from 5% in early 2000 to just 1.4% later in the year. In response, the Federal Reserve has cut interest rates four times since the start of 2001. The Japanese economy is estimated to have grown by just 1.9% in 2000 (NIESR), well below the world average. Between December 2000 and January 2001 Japanese industrial production fell by 3.9%, the largest drop since 1993, and interest rates have been reduced in an attempt to increase demand and help end the prolonged period of deflation. Japan is the only developed economy to have experienced true deflation since the 1930s.

US growth had been driven in part by faster productivity growth based upon increasingly higher ratios of capital equipment to workers, and a stream of technological innovations. However this 'capital deepening' is now set to decline, and is coupled with heavy borrowing by households and consumers, overvalued share prices, and a growing current account deficit – all features which have preceded previous recessions. Last year was the first since 1990 that the blue-chip Dow Jones industrial average finished lower than it had started, and the worst year ever for the Nasdaq (technology stocks). Although the Nasdaq index rallied after the US interest rate cut in January, (gaining 25%), this was lost by the end of February and has since fallen further. Internet and technology companies, such as Cisco, Sun Microsystems, JDS Uniphase and Amazon are all trading at low levels. Forecasts for the Standard & Poor 500 (S&P 500), dominated by larger companies, have been revised down from an early December forecast of 11.5% growth in profits to 4.5% by March this year.

The falling Nasdaq certainly reflects deteriorating consumer confidence. However, there is capacity in the US economy, in the absence of inflation, to relax monetary policy by further cutting interest rates to bolster consumption. It seems likely that further interest rate reductions will occur through the year.

In Japan share prices have also plummeted, with the Nikkei average of leading shares 40% lower in February 2001 than one year earlier, down to a fifteen year low. Japanese investors are also concerned about bank solvency and, as a result, business confidence amongst small and medium sized establishments (which employ 80% of the workforce) has deteriorated. In response, the Japanese government has announced emergency packages aimed at strengthening the banks. However these packages have been criticised for failing to recognise the true scale of the problem, and following the unveiling of the plans this April, the stockmarket fell once again.

### Europe

Germany's GDP growth fell from over 4% pa in the first half of 2000 to just 0.8% by the final quarter of 2000. Despite this, economic growth in the Euro zone remained a respectable 2.5%, propped up by strong growth in France and the Netherlands of 4% and 5% respectively in 2000Q4.

European exports to the US comprise only 2.5% of GDP, so a US downturn will not *directly* affect output. More significant will be the impact on European stockmarkets. However, the relationship between consumer confidence and share price changes in Europe is weaker than in the US, since share ownership is less predominant amongst European households. As a result, forecasts for the Euro zone have only been modestly revised for 2001 from 3.1% to 2.6%; in contrast to the average forecast for the US having plunged from 3.5% to 1.8%.

The main areas of concern for the European economy are inflation and a weak Euro. Although inflation fell in the Euro area to 2.4% in January 2001, it remains above the ECB's ceiling of 2%, hence the Central Bank's previous reluctance to cut interest rates. Following the April interest rate cut in the US, the ECB no longer remains confident that the Euro-zone economy is insulated from troubles in the US, and lowered interest rates to 4.5% in May.

## The UK Economy

Growth in the UK economy slowed in the final quarter of 2000, largely as a result of output declines in the oil and gas extraction industry. Only recently have business surveys turned gloomy, with the CBI reporting a weakening in exports. Despite stock market fluctuations in early 2001, exemplified by the FTSE 100 index dropping nearly 91 points in mid March to end at its lowest close since February 1999, consumer confidence remains firm. However, as expected, the Bank of England's Monetary Policy Committee (MPC) cut interest rates by a quarter point in April, reducing the base rate to 5.5%, with a further cut in May to 5.25%, in order to maintain demand. The MPC said these decisions were made as a result of global economic slowdown, recent equity market declines and foot-and-mouth disease.

However, such a strategy to prop-up demand is not without problems. Although lower income families and households with children were targeted with tax cuts in the March budget, the new (net) tax reductions will stimulate household expenditure. Further, nearly £1 billion a year of new public expenditure was announced, which may also induce inflationary pressure.

The UK is now experiencing its lowest recorded unemployment in a quarter of a century, accompanied by record numbers of unfilled vacancies of 395,000 in January 2001. This could result in significant earnings growth, and higher prices, as producers pass rising labour costs onto consumers.

One of the most controversial issues during 2000 was the sharp rise in the price of petrol, which culminated in widespread protests in September. The price of crude oil had risen steadily from just under $10 per barrel (February 1999) to around $27 by September 2000. As a consequence the price of petrol had also increased from an average price of 65.27p in 1998 to 79.9p by the end of 2000 (a 22% increase). While recent crude oil price rises have been comparable to those experienced during the OPEC crisis of the 1970s, they have not generated inflation, as was the case three decades earlier. The economy is now less oil dependent than it was in the 1970s, since production techniques are more efficient or use alternative fuels, resulting in lower sensitivity to such variations.

Forecasts for growth in the UK economy in 2001 average 2.4%, and range from 3.2% to 1.7% (HM Treasury, *Forecasts for the UK Economy, A Comparison of Independent Forecasts*, April 2001).

## The Welsh Economy

In recent months, Wales has been hit hard by a series of job loss announcements, most notably in the manufacturing sector. In particular, during last Autumn, several consumer electronics manufacturers reported that redundancies would be made across South Wales plants over the coming year. In January 2001, Corus announced that 2,500 jobs would be lost in its Welsh plants. Since then unions and the National Assembly have been negotiating with Corus in the hope of a partial reprieve, at least. There has been better news elsewhere. For example, Ford at Bridgend are to build the latest line of Duratec engines, whilst the wings of the Airbus A380 super-jumbo are to be manufactured at Broughton in Clwyd creating well over 1,000 jobs (see Economic Events Diary).

The weak Euro continues to make Welsh exports to Europe comparatively expensive, and this has been partially blamed for Welsh manufacturing problems, (although the interest rate cuts made by the MPC should ease these difficulties). A survey conducted jointly by Cardiff Chamber of Commerce and the Royal Bank of Scotland of 3,000 South Wales businesses revealed a weakened export performance. The net balance of manufacturing overseas sales fell by 5% in the last quarter of 2000.

There has been job creation outside the manufacturing sector during the last year. However, for the tourism, agriculture and other related sectors, the short to medium term outlook depends critically on the impact and duration of foot-and-mouth disease.

## Forecasts

UK consumer confidence and demand remain fairly strong (propped up by recent interest rate reductions), as evidenced, for example, by retail sales growth data, which shows annual sales volume up by almost 6% in the year to February 2001. This figure compares favourably to other European countries, (the Euro zone average was 2.3%) and to the US, where retail sales grew by just 1.5% over the same period. However, the UK economy in 2001 is unlikely to perform as well as previously expected. Downward revisions to economic forecasts are anticipated as a result of global and local economic conditions.

The last issue of the *Welsh Economic Review*, forecast change in real GDP (ie adjusted for price changes) of 2% for 2001 and 2.1% for 2002. Some parts of the Welsh economy, particularly the public sector (as a result of announced increases in planned expenditure), and other parts of the service sector, are expected to grow over the short term. However the GDP impact of this growth will be countered by declining economic activity in the production sector of the economy. Added to this are short term uncertainties in the tourism sector in the wake of foot-and-mouth disease. As noted in the *Industrial Activity* section later in this *Welsh Economic Review,* prospects for parts of manufacturing sector and the utilities sector are poor, as the full effects of industry downsizing or closure are felt on the local economy. As a consequence of these expected impacts, the WERU forecast for Welsh GDP in the period 2001 and 2002 has been revised downwards. In line with an expected improvement in World and UK economic prospects, the forecast growth rate is slightly higher in 2002 and 2003 than in 2001. (See table 1).

**Table 1 Forecast Change in Real GDP (%)**

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Wales | 1.3 | 1.5 | 1.8 |